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RURAL BANKING IN A HOSTILE ENVIRONMENT: SURVIVAL MEASURES

by

Claudio Gonzalez-Vega

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Agricultural Finance Program
Department of Agricultural Economics
and
Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210-1099

Abstract

This paper explores the requirements and determinants for the institutional viability of rural financial intermediaries in the developing countries. It identifies the constraints on viability resulting from a hostile environment, characterized by inflation, terms of trade and other relative price changes, and increased risks. It recommends survival measures for rural financial institutions engaged in a process of restructuring while facing this hostile environment.

RURAL BANKING IN A HOSTILE ENVIRONMENT: SURVIVAL MEASURES

Claudio Gonzalez-Vega[1]

I. Introduction

There has been an increasing preoccupation among bankers, representatives of international agencies, and the financial authorities of the developing countries, as well as among academics and professionals concerned with economic development, regarding the performance of agricultural development banks and other specialized rural financial institutions.[2] This concern has reflected a better understanding of the importance of the efficient provision of financial services for rapid, widespread, and sustainable rural development. It has reflected, in addition, frustration with the failure of traditional agricultural credit programs and with the obstinacy of the urban bias of financial development as well as concerns that an unstable macroeconomic environment and generalized distress in several financial systems will make the recovery and viability of many rural financial institutions even harder to achieve.

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[1] Claudio Gonzalez-Vega is Professor of Agricultural Economics and of Economics at The Ohio State University. Previously, he was Dean of the Faculty of Economic Sciences at the University of Costa Rica. This paper was prepared for the Fifth SACRED Consultation, Food and Agriculture Organization (FAO), Rome, April, 1991. Only the author is responsible for the views expressed here, which may or may not be shared by the sponsoring institutions.

[2] An earlier concern with the performance of agricultural development banks was voiced by the Rural Financial Markets Program at the Ohio State University, as summarized by Compton Bourne and Douglas H. Graham in "Problems with Specialized Agricultural Lenders," in Dale W Adams, Douglas H. Graham, and J. D. Von Pischke, eds. Undermining Rural Development with Cheap Credit, Boulder, Colorado: Westview Press, 1984.

Many of these specialized rural financial institutions were created with the objective of supplying, either the longer-term credit that commercial banks were not prepared to grant, or the loans demanded by specific clientele, such as medium and small farmers, who lacked access to the financial services of the traditional banking sector, but who were considered to be a priority by the governments of the developing nations. Typically, however, these target clientele have been among the riskiest and costliest to supply with financial services. Mostly publicly-owned, the rural financial institutions have received the largest share of their funds from international agencies, governments, or central banks, and have granted their loans to beneficiaries who have not always possessed the requirements of creditworthiness, frequently at subsidized interest rates.

Created with the best of intentions, in practice these rural financial institutions have found it difficult to target subsidized loans, postpone concerns about creditworthiness and risk management, and remain financially viable at the same time. As a result, many of them have required frequent new capitalizations and many are insolvent today. If they are to remain in operation and expand the scope of their activities, they will have to be restructured. Such an institutional transformation has become a difficult task in the hostile environment of the 1980s and 1990s. This paper explores requirements for institutional viability in rural financial markets, identifies constraints resulting from this hostile environment, and recommends survival measures for rural financial institutions of developing economies presently engaged in a process of restructuring, or planning to do so in the future, in order to achieve their viability.

II. Institutional Viability

The main problem of these rural financial institutions has been their lack of viability. A viable financial institution is self-sustaining and valued by its clientele. This requires an agency that is able to cover its costs, that provides high quality services, that reaches an increasing number of customers, that is dynamic in providing new financial services and products, and that actively searches for ways of improving its efficiency, as reflected, in turn, by the level and the degree of dispersion of the transaction costs incurred by its depositors, its borrowers, and the intermediary itself. Viable institutions possess credibility and are able to mobilize deposits from the public, collect their loans, and retain good management and staff.[3]

The lack of viability of many rural financial institutions has been reflected by the steady reduction of their relative importance within the financial sector of the developing countries, as most of them have not been able to increase and, in many instances, even to sustain the flow of their loanable funds, in real terms. On the contrary, their lending capacity has sharply decreased over time, because they have not protected their portfolios from inflation, they have not vigorously collected their loans, in order to be able to grant new credit, they have not aggressively mobilized local resources, in order to be able to widen the range of their services, and because, in view of the poor quality of their services and the high transaction costs that they impose, they have lost the support of their clientele.

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[3] See Richard L. Meyer, "The Viability of Rural Financial Institutions and the System as a Whole," Report of the Fourth Technical Consultation on the Scheme of Agricultural Credit Development, Rome: FAO, 1988, pp. 41-44.

As their institutional weaknesses have become increasingly evident, these rural intermediaries have lost the support of the international agencies as well and, as a result, their loanable funds have further substantially declined. Ironically, their lack of viability has been, in large part, a consequence of their strong dependency on these outside funds, from international donors, central banks, and governments. Given this strong financial dependency and a limited mobilization of deposits from the public, there has been a significant political intrusion in the agricultural development banks and other specialized rural lenders, in the sense that the decisions about who to lend to, what to lend for, and in what terms and conditions to lend have not been autonomously made by the financial intermediary, but have been imposed from the outside by the external sources of their funds. The criteria used have not necessarily been compatible with the viability of many rural financial institutions.

Lacking viability, their survival has been questioned by many, including their own clientele. Increasing levels of loan default have evidenced this loss of the support of their customers. Loan delinquency has been a signal that the borrowers have not been interested in the survival of the institution. Since they have not anticipated it to be able to provide a permanent service, the expected value of their relationship with the intermediary has been low, and they have not protected it with the timely service of their loan obligations. Furthermore, where they have not mobilized voluntary deposits from the local community, these rural financial institutions have lost the potential support from a mass of depositors. Where available, the quality of the services provided to the depositors has determined the extent of their support and, thereby, the institution's ability to grow on the basis of locally mobilized resources.

A greater reliance on deposit mobilization has been critical, however, at a time when severe fiscal constraints have reduced the ability of governments to capitalize these institutions with budgetary transfers, when the targets of macroeconomic stabilization programs have eliminated their access to central bank rediscounting and other domestic lines of credit, and when the international debt crisis has reduced their access to foreign savings.

Some public agricultural development banks have retained, however, the support of local politicians, who still see them as mechanisms to favor some groups at the expense of others, namely, as instruments for political patronage. Their lack of viability has reflected, precisely, these high levels of political intrusion and the biasing of their objectives away from efficient financial intermediation and towards other political goals. Frequently, the management autonomy of these institutions has been less important than these non-financial objectives. These institutions have been expected to promote the growth of agricultural production, regional development, the adoption of new technology and/or agrarian reform. As long as available funds were apparently abundant, there was little concern with the sound growth of the financial institutions per se. They were utilized as instruments to promote other development objectives, even if these purposes created excessive costs and risks for the institutions.

In order to survive, however, rural lending institutions must now emphasize their role as financial intermediaries. They must operate under the premise that the efficient provision of financial services is an important contribution to economic development per se. Instead of attempting to promote the production of particular crops or the adoption of specific technological practices, they must recognize that the role of financial intermediation is actually to improve efficiency via the reallocation of resources through the discipline of the market mechanism. This is particularly important in countries where the authorities are implementing a program of structural transformation that allows a greater role for prices and the allocation of resources according to comparative advantages. In such cases, what must be emphasized is the performance of these institutions as intermediaries between depositors and borrowers.

The traditional credit programs, designed from a different perspective, mistrusted the market and minimized the role of interest rates as a tool for resource allocation. Those programs elected, instead, the administrative determination of who to lend to and what to lend for. Interest rate controls have been particularly ineffective, however. Savers have avoided bank deposits when the rates of interest paid have been repressed, while informal, non-regulated, parallel markets have flourished instead.

Supervised credit programs have not trusted farmers, either, while insisting on rigidly targeting credit and on a detailed supervision of the use of the funds. These efforts, despite their good intentions, have resulted in unexpected negative consequences. The fungibility of funds has frustrated attempts to control end uses. Rationing, in the presence of excess demands created by underpriced credit, and excessive supervision have both increased transaction costs, for the intermediaries as well as for the borrowers. Rigid credit programming, although usually fruitless, has thus been expensive for all market participants and specially for marginal customers with small loans. Institutional viability will require lower operational costs and better quality of service, while greater economic efficiency will result from more decentralized decisions about resource allocation.

What matters is the creation of creditworthiness; the existence of economic agents able to borrow, to pay market interest rates, to efficiently use funds, and pay loans back. Timely, untied, flexible loans and secure, low-cost depositing facilities would allow these creditworthy agents to improve their financial management and increase their productivity. What matters are financial intermediaries capable of identifying these creditworthy agents at a low cost and of servicing their varied demands for financial services as well as of timely collecting their loans. What are needed are viable institutions, capable of offering a wide range of financial services, to an ample and diversified rural clientele, independently of the end use of the funds.

The traditional agricultural credit programs were characterized, in addition, by borrower domination. Practices and operational procedures were designed with the interests of just the borrowers in mind. The rapid disbursement of the funds was favored, target clientele were chosen independently of their repayment capacity, and credit was subsidized. In a depositor-dominated institution, on the other hand, practices and procedures seek to protect the depositors' savings. The borrowers' repayment capacity is taken more seriously, efforts towards loan collection are emphasized, and portfolio diversification is used as a risk management tool, avoiding the concentration of the portfolio in a few crops or activities. Many rural financial institutions have been pessimistic about opportunities for the successful mobilization of local deposits, however. They have assumed that rural households do not save, do not want to transform some of their assets into deposits, and do not react to changes in interest rates and other economic incentives.

Those few institutions that have emphasized savings mobilization have been more successful, however.[4] They have discovered that there is a high demand for deposit facilities in the rural areas of the developing countries and have successfully tapped these additional loanable funds. The depositors are the financial institution's best ally, indeed. Their concern for the safety of their deposits contributes to the protection of the intermediary's interests as well. The key is to make deposit mobilization voluntary. The client must view deposit facilities as a valuable service and not as an imposition or as a mere tool to increase the effective cost of the loans. What matters is the quality of service to the client. Quality promotes client support, the healthiest way for an intermediary to grow.

III. Evaluating Financial Intermediary Performance

Several performance dimensions characterize a viable financial intermediary. First, the viability of a system of rural financial institutions increases to the extent to which they provide access to a wide range of financial services for wide segments of the population, including loans for different purposes as well as deposit facilities, mechanisms for the transfer of funds and currency exchanges, and other specialized services, once market size grows sufficiently. In particular, there is a high demand for deposit facilities in the rural areas of the developing countries, given household-farm requirements for liquidity management and reserve accumulation. While not all producers need credit, all of the time, practically all economic agents demand liquidity management facilities, such as deposit opportunities, most of the time.

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[4] Claudio Gonzalez-Vega, "Strengthening Agricultural Banking and Credit Systems in Latin America and the Caribbean," Rome: FAO, Agricultural Services Division, 1986.

Second, the viability of rural financial institutions is strengthened to the extent to which they transfer growing volumes of purchasing power, from depositors with limited investment opportunities, to borrowers with better productive options. In effect, the contribution of financial intermediation to economic development consists of the transfer of resources, from less productive uses, to activities where they can be more profitably employed. In this way, deposits substitute for less attractive uses of the funds, while loans make better uses possible. The extent to which intermediation increases efficiency and, at the same time, the viability of rural financial institutions depends, in turn, on the amounts of purchasing power so transferred. What matters is the real value of the channelled funds; their command over resources. What matters is not how many million dollars of credit are granted, but how much seed, fertilizer, or heads of livestock can be purchased with those loans.

The creation and conservation of purchasing power has both macroeconomic requirements and intermediary-level implications. At the macroeconomic level, to create dollars is easy; they may be issued by the central bank. To create nominal credit is easy, as well. To create purchasing power, on the contrary, is very difficult. This requires that economic agents be capable and willing to save. In addition, they must be willing to place their savings with the financial institutions.[5]

[5] See Claudio Gonzalez-Vega, "The Ohio State University's Approach to Rural Financial Markets: A Concepts Paper," Columbus: The Ohio State University, Rural Financial Markets Program, 1986.

The purchasing power channelled through the financial system increases only if income grows and if economic agents find incentives and opportunities to save and to deposit. To attract the depositors is thus a necessary condition for the transfer of purchasing power from surplus to deficit units. This poses a potential conflict, since the interest rates attractive to depositors increase the cost of funds for the borrowers.

Inflation erodes the purchasing power of both deposits and loan portfolios. To avoid this loss, depositors transfer their purchasing power to other assets that are better forms of holding wealth in an inflationary economy, because they conserve value: real estate, inventories, precious metals. Similarly, to avoid the threat to their purchasing power from devaluation, depositors buy foreign currencies or open bank accounts abroad. The consequences are a reduction of the real value of the deposits held in the domestic financial system and of the local lending capacity.

The main responsibility of a financial intermediary is, in turn, to keep the integrity of its loanable funds. The intermediary keeps those funds in custody, in the name of depositors (or international agencies) that entrusted those funds, so the lender could, in turn, facilitate the borrowers' productive activities. If the lender does not protect those funds, it breaks its agreement with the depositors, who expect to recuperate the wealth made available to others. If this purchasing power is not protected, the intermediary will find it impossible to offer loan services to its borrowers, when they need its support.

To keep the integrity of its loanable funds, the intermediary must avoid the erosion caused by inflation. This will only be possible if the rates of interest charged are positive in real terms; that is, if they are higher than the inflation rate.

Since depositors look for protection from inflation, as well, the intermediary must pay a positive real rate of interest for the savings mobilized. The institution's interest rate policies must respond, therefore, to expected inflation rates. An intermediary that charges only 50 percent of nominal interest on its loans, with an inflation rate of 100 percent per year, will experience, on this account only, a reduction of the purchasing power of its portfolio to two-fifths of its original value in only three years. After such a reduction in the purchasing power of its portfolio, the rural financial institution will be in a position to offer the same credit service to only 40 percent of its original clientele. If it tried to service all of these clients, it could offer no more than 40 percent of the purchasing power originally transferred. One way or another, the quality of service would have deteriorated and the institution would lose the support of both its depositors and borrowers.

Inflation forces the financial institution to revise its procedures. Accounting practices must be modified, in order to reflect the real value of assets and liabilities and to avoid decapitalization. The greater variability of prices that usually accompanies an inflationary process, frequently coupled with selective price controls, makes the evaluation of lending risks even more difficult. Portfolio management practices need to be revised to take inflation uncertainty into account.

In order to keep the integrity of its loanable funds, an institution must avoid operational losses as well. This implies both a reduction of operating costs, avoiding waste and inefficiency, as well as sufficient revenues. Effectively earned (rather than simply accrued) interest is the main source of revenues for a financial intermediary. The rate of interest charged on the loans must cover expected inflation and the institution's operating costs, at the same time that it makes it possible to build sufficient reserves against default losses and it offers an attractive remuneration to the depositors. To achieve this balance is not an easy task. In order to keep the integrity of its loanable funds, the institution must also collect its loans. An intermediary that each year loses 40 percent of its portfolio because of default will lose its capital as with an equivalent rate of inflation and its loanable funds will similarly disappear.

Third, a rural financial institution will be viable to the extent to which it offers high-quality services. A farmer is interested not only in sufficient purchasing power from the loan; he also wants the funds to be timely disbursed, the loan procedure to be easy and flexible, the amortization schedule to adequately correspond to his cash flow, and the loan term to be sufficiently long. All of these features determine the quality of service. The farmer wants, in particular, access to a financial institution that offers timely, reliable, encompassing, and permanent services.

It is not always easy to establish creditworthiness. For this purpose, what is most important is for the lender to acquire enough information about the borrower, in order to be able to estimate the probability of lack of repayment. This information is accumulated through experience and a continued relationship with a particular client. Once his reputation as a good borrower has been established, the client protects it, since it is a valuable intangible asset. This asset is more valuable if the credit program is permanent rather than transitory. The borrower also expects the program to be reliable; the expected losses from lack of access to credit when this is needed, such as during an emergency, can be high. Untimely service and delays in disbursements cause additional costs for the producer.

The more complete the service, such as in a "financial supermarket," the greater the convenience and less the cost for the client. There are many advantages for the client from holding his deposits and conducting his credit transactions at the same institution. The client's first interest is, therefore, a viable institution, with which to develop a long-term relationship. This is, indeed, the nature of his implicit contract with the informal money-lender. An intermediary that is not valued by its customers is not viable.

Fourth, the viability of a rural financial institution is strengthened when it offers low-cost services. This does not mean that interest rates must be kept at artificially low levels. What would be the value of too low an interest rate, if the loans are disbursed several months later, when they are not needed any longer, or if the expenditures that the farmer wants to make are not authorized? What would be the value of an artificially low interest rate, if it decapitalizes the intermediary to the point that it has to drastically reduce the amounts that it can lend? What would be the value of subsidized credit, if the farmer can get it this year, but not the next?

Financial services are never cheap. The operation of the financial system is costly both for the intermediaries and their clientele. What matters, for production and investment decisions, is the total cost of the funds for the borrowers. Interest payments are only a portion of these costs, frequently not the most important. There are other implicit costs, such as the opportunity cost of the time spent in the transaction or the losses due to delays in the disbursement of the funds. There are legal expenses, commissions, taxes, travel costs, and bribes. There are risks of losses of collateral. When these other costs are high, loans are expensive.

What matters for the behavior of savers is the net return on deposits, once taxes, travel expenses, and the cost of standing in line at a bank branch are subtracted from interest earned. What matters for the intermediary is a financial margin that covers the costs of funds mobilization and the costs and risks of lending and that leaves a profit that allows for growth. A public or private financial intermediary that is not profitable, stagnates, and if it makes losses, it shrinks and it disappears.

The main indicator of financial progress is a reduction in the transaction costs incurred by all, actual and potential, market participants. A reduction in these costs that, among other things, allows a shrinking of financial margins, is the most effective way to simultaneously favor both borrowers and depositors. If the intermediary operates with smaller margins, it will be in a position to offer a more attractive rate of interest to depositors, while at the same time it charges less to its borrowers. The ultimate challenge is this greater efficiency, that reduces the potential conflict between borrowers and depositors.

Financial intermediaries contribute to economic development if, once all of these uses of real resources are taken into account, their operations imply low costs, for the clientele and for society as a whole. Too high costs imply a waste of resources, that could be more profitably employed in other activities: the farmer cultivating his farm, instead of traveling to the bank in order to find out what ever happened to his loan application; the depositor looking after his business, instead of waiting in line for hours at a branch; the redundant employee of a financial institution contributing with his efforts to another productive activity. Interest-rate ceilings cannot eliminate excessive costs. The search for financial viability will.

The limited success of specialized rural credit institutions has reduced enthusiasm in the search for an ideal type of financial intermediary. Rather, the purpose of policy should be the creation of markets, when these are absent or incomplete, the improvement of market performance, when this is not efficient, and the use of the power of financial markets to integrate other markets across the economy.

Different institutional types possess comparative advantages to reach different clientele and to provide diverse classes of financial services. What matters, therefore, is the performance of the whole system, where numerous and diverse market participants are linked through flows of funds and of information. Thus, economic agents who borrow in one market, may lend in another, thereby reducing overall transaction costs and contributing to greater market integration. What matters is the identification of the optimum division of labor among several institutional classes. For this, the policies that guide their behavior are more important than differences in institutional type. Incorrect policies send wrong signals to all kinds of financial intermediaries, independently of their organizational structure. This is why a regulatory environment that promotes, rather than represses, competition is critical.

IV. Determinants of Viability

The determinants of the viability of a rural financial institution may be classified into four classes:

(a) the environment in which the institution operates;

(b) the financial policies that regulate the institution's behavior;

(c) the institution's organizational structure and procedures; and

(d) the financial technologies employed by the institution.

The characteristics of the rural economy represent a major dimension of the difficult environment in which financial institutions operate.[6] Potential depositors and borrowers are heterogeneous and geographically dispersed, their transactions are small, and the risks implicit in their productive activities are high, because the outcome of their efforts is highly dependent on exogenous forces. In addition, the physical and institutional infrastructure and the provision of public services are limited, input supplies are unreliable and marketing networks and systems are undeveloped, the levels of education and of human capital formation are low, information is scarce and costly, the size of most local markets is very small, and the institutional organization of the rural economy is incomplete.

The consequences of this fragmentation, limited market integration, and incomplete institutional organization are high transaction costs and high risks. Both reduce the demand for and the supply of rural financial services. In these circumstances, to become a viable financial intermediary is a very difficult task. Potential depositors find that the net returns on their deposits are low and save in other, non-financial forms. Potential borrowers find that the total costs of formal loans are high and seek informal sources of credit for which transaction costs are lower. Rural financial institutions discover that the costs of administering a multitude of small savings accounts and the costs and risks of evaluating and administering a multitude of small loan contracts are high. For these reasons they frequently offer neither deposit nor credit services, except to a few large clients.

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[6] See Claudio Gonzalez-Vega, "On the Viability of Agricultural Development Banks: Conceptual Framework," and "Evaluating the Viability of Agricultural Development Banks: A Methodology," papers prepared for the Inter-American Development Bank, April, 1990.

Numerous elements of the physical, technological, and institutional environment determine the profitability and risks of agricultural activities and, as a result, the profitability and risks of loans to farmers. The growth potential of a rural financial intermediary depends to a large extent on the solvency and dynamism of its clientele. Farmers with low and unstable returns cannot become good clients. Low incomes limit their savings capacity and their ability to transform some of their assets into financial deposits. Low and variable incomes reduce their desire to borrow, limit their opportunities to profitably use loan funds, and diminish their ability and willingness to repay loans.

Rural financial institutions will be more viable when farmer returns are high, rural incomes grow, and policies do not discriminate against farming. The development of the country's infrastructure, greater security in land tenure arrangements, and a legal framework that protects property rights and the enforcement of contracts increase resource productivity and reduce transaction costs and, in this way, promote the viability of rural financial institutions.

Regulations regarding financial contracts, property rights, bankruptcy, and procedures to seize collateral in case of default are necessary for the viable operation of institutional intermediaries that cannot rely on collateral substitutes. Creditworthiness greatly increases when the rights of rural financial institutions in case of bankruptcy are adequately protected and when the borrowers can provide collateral. For this, it is important that property rights be adequately registered and easily transferable. Rights and responsibilities of depositors, borrowers, and intermediaries under financial contracts must be clearly spelled out and enforced.

One of the most important goals of the supervision of financial intermediaries in advanced economies is to ensure that portfolio assets do not become too concentrated in a single firm or subject to a common source of risk. This objective is very difficult to achieve in the rural financial institutions of developing countries, where all of the potential customers may be equally affected by shocks to commodity prices or crop conditions. These limited opportunities for portfolio diversification represent one of the major drawbacks of specialized rural financial institutions, whose clients may be engaged in the production of only a few goods, sold only in a limited number of markets. The problem is accentuated by the higher variance of returns displayed by agricultural production. Financial intermediary supervision is further complicated by inadequate supporting structures, such as lack of accounting standards. The lack of accounting standards makes it difficult not only to appraise and evaluate the creditworthiness of a potential client, but also to determine the quality of the intermediary's assets.

In addition to the price policies, taxes and subsidies that critically influence farmers' incomes, appropriate macroeconomic management and financial policies are crucial for the viability of rural financial institutions. A cautious macroeconomic management promotes stability and protects financial transactions from inflation and the overvaluation of the domestic currency. Austere fiscal policies reduce the crowding out of private-sector firms from the portfolios of the domestic financial system. Effective prudential supervision of financial intermediaries promotes their solvency and, thereby, the public's confidence. This trust is indispensable for firms and households to channel their savings through rural financial intermediaries.

Rigid financial policies have repressed the performance of rural financial institutions in many developing countries. Combined with inflation and devaluation expectations, interest-rate restrictions have resulted in negative net returns for depositors, in real terms, and have promoted dollarization and the contraction of regulated financial institutions, while a few privileged borrowers have received substantial implicit subsidies. High and differential reserve requirements have increased the margins between deposit and loan rates of interest and have further reduced the availability of loanable funds. They have been part of the complex mix of explicit and implicit taxes and subsidies that the fiscal authorities have imposed on the financial system and have created a significant scope for the collection of the inflation tax revenue directly from the financial institutions, which have been required to increase their holdings of non-earning reserves as the price level increased. Restrictions on portfolio selection have seldom matched the available loanable funds with the most productive investments. Instead, these funds have ended up financing government deficits or the capital-intensive projects of large protected firms.

Interest-rate restrictions have forced many intermediaries to adopt non-price rationing criteria that have penalized "difficult" clientele, including small farmers. When the lending institutions have not protected their portfolios in this way, they have rapidly become decapitalized. The viability of rural financial institutions requires, therefore, a policy and regulatory framework that gives them more freedom to determine the terms and conditions of their deposit and loan contracts, such as the setting of interest rates, and that avoids the targeting, selective credit controls, and other attempts at exogenously constraining the allocation of loanable funds.

In order to be viable, rural financial intermediaries need to become independent, permanent, and efficient institutions. Inconsistent objectives reduce their viability. Excessive specialization increases their risks. Lack of deposit mobilization weakens their ability to take advantage of economies of scope. Institutional performance is determined largely by the behavior of managers, employees, and customers. The incentives and reward structure that guide the actions of these agents and sufficient accountability for the consequences of their decisions are critical.[7] Also important is enough authority to evaluate loan applications with independence and collect loans with energy.

Political intrusion and other interferences with the institution's decision-making process, on the part of governments, international agencies, and domestic interest groups, may reduce the institution's viability as well. A much lesser reliance on external funds and a greater reliance on deposit mobilization would then contribute to a lower degree of outside interference with the bank's decisions.

Risks are inherent in financial intermediation: loans may not be repaid, deposits may be withdrawn, interest and exchange rates may fluctuate, and the external environment (state of the economy) may change. The management of these risks requires technical and organizational skills, good judgement, and adequate internal controls. When management is weak, the intermediary will not be able to control these risks and is likely to make wrong decisions that lead to losses. Many rural financial institutions have lacked experienced staff, have adopted poorly designed procedures, or have attempted to expand too rapidly, losing control over their operations.

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[7] Avishay Braverman and J. Luis Guash, "Rural Credit in Developing Countries," Washington, D.C.: The World Bank, Working Paper WPS 219, 1989.

Rural financial institutions must have, in particular, accurate, timely, and reliable information to plan and to measure performance, in order to achieve and sustain growth in portfolios and earnings under variable conditions. Information helps to measure the inherent risks in lending as well as in funding loan portfolios and forms the basis for early and informed decision-making. The deterioration of many rural financial institutions in the hostile environment of the 1980s was significantly aggravated by the lack of timely and useful financial information available to their managers, that would have enabled them to take early, appropriate corrective actions, and to continuously monitor the impact of their decisions.

The viability of rural financial institutions depends on the adoption of new financial technologies, needed to increase access to services for larger numbers of customers, to improve the quality of the services provided, and to reduce transactions costs both for the intermediary and for its customers. Instruments and procedures must be evaluated in order to determine the extent to which they could improve risk management. New mechanisms are indispensable to more efficiently collect, process, and take advantage of information for decision-making.

Access to appropriate financial technologies is indispensable for the expansion of the supply of financial services when markets are being deregulated. Unless transaction costs are significantly reduced for all market participants, it will continue to be impossible to provide financial services to a wide rural clientele, despite ambitious policy reforms. Unless new financial technologies substantially reduce these costs, it may be impossible to improve the institutional viability of many rural financial intermediaries.

V. Intermediary Viability in a Hostile Environment

Many developing economies, particularly in Africa and Latin America, experienced severe economic problems during the 1980s, including the abrupt cessation of their access to foreign lending, much higher real rates of interest in both domestic and international financial markets, and a sharp decline in the international demand for, and the prices of, their export commodities, leading to a deterioration of their terms of trade and to much lower rates of economic growth. Most of these countries no longer possessed the foreign exchange to finance their excessive balance of payments deficits and were forced to devalue, in order to discourage imports and stimulate exports. Growing fiscal deficits fueled, in turn, accelerating domestic inflation, followed by the crowding out of private sector firms in domestic credit portfolios. It became even harder to sustain the viability of rural financial institutions in this hostile environment.

Most alarming has been the acceleration of inflation. The average rate of inflation for the developing countries rose from 10 percent for the 1965-73 period, to 26 percent for 1974-82, and to 51 percent during 1983-87.[8] Inflation has been a result, in most of these countries, of too rapid a nominal expansion of domestic credit and, as a consequence, of money supply compared to the demand for the money. The accelerating growth of domestic credit has mostly reflected, in turn, the financing of growing public-sector budget deficits as well as substantial quasi-fiscal transfers to the private sector and a multiplicity of subsidies, including underpriced credit.

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[8] Millard Long, "Financial Sector and Economic Development," Denmark: International Conference on Savings and Credit for Development, 1990.

By directly levying a tax on the public's holdings of the liabilities of the domestic financial system, inflation has been this sector's worst foe. When it has accelerated, it has quickly destroyed the financial system of many developing countries. Both inflation and the demand for the foreign exchange needed to service many developing countries' external debts have, in turn, exerted upward pressure on the exchange rate. The resulting devaluation expectations have further jeopardized the performance of the domestic financial system, by increasing the relative attractiveness of holding foreign rather than domestic financial assets.

Non-inflationary financing of the public sector deficits has presented problems of its own, frequently leading to the crowding out of private borrowers in domestic credit markets. High reserve requirements used to reduce inflationary pressures have caused wide spreads in the operations of financial intermediaries and have similarly reduced the supply of credit for the private sector. In insufficiently developed money and capital markets, large volumes of non-inflationary financing of public sector deficits have been directly reflected in very high real rates of interest, thus inducing the crowding out of the private sector through the cost of the funds.[9] Rural financial institutions have usually been crowded out, in turn, by other public sector agencies with more senior claims and, when stabilization programs that have sharply reduced budget deficits have been implemented, rural financial institutions have lost their privileged access to government and central bank lines of credit.

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[9] See Alan Roe and Paul A. Popiel, Managing Financial Adjustment in Middle-Income Countries, Washington, D.C.: The World Bank, EDI Policy Seminar Report No. 11.

Recessions have reduced the incomes of rural producers, devaluations have increased the burden of debts denominated in foreign currencies, and higher real interest rates have made loans more difficult to service. The profitability of producers of non-traded goods has declined with devaluations. As a consequence of fiscal austerity many subsidies to rural producers have been terminated. As a result, many borrowers have been unable and/or unwilling to service their loan obligations and the level of arrears in the financial system, including the rural financial institutions, has increased considerably, further decapitalizing these intermediaries.

Many of these financial institutions have rolled over loans that were non-performing, particularly in the case of the largest borrowers, hoping to avoid bankrupcy by keeping their clients in operation, and have thus constrained the flow of new loans for investment. In order to restore their viability, these institutions need to stop the accrual of unpaid interest, must eliminate rollovers and the refinancing of non-performing loans, and should make appropriate provisions for bad debts. Those intermediaries that have no capital must be recapitalized, merged with more solid institutions, and/or closed, when they are no longer viable.

There are several adverse consequences from the continued operation of seriously impaired rural financial institutions. This weakens rural financial markets and makes them more prone to crises. Further, the bailing out of institutions puts pressure on the authorities for support and subsidies, with additional fiscal costs, and for restrictive practices, that limit competition in the sector. Intermediation margins are widened and resource allocation is distorted in favor of non-performing borrowers at the expense of productive enterprises.

Moreover, the structural adjustment reforms undertaken in many developing countries do not immediately improve the environment for the rural financial institutions. A particularly difficult dilemma arises from the fact that many components of structural adjustment programs inevitably exacerbate financial distress, as they change relative prices and reduce the profitability of activities financed by these intermediaries before the policy changes were adopted, with long-term loans still in their portfolios. The reduced profitability of these previously protected producers leads them to default on their loans. This is not a reason for holding back from these structural adjustment reforms, but potential problems must be recognized and anticipated. Moreover, structural adjustment programs may create new foreign exchange and interest rate risks for the rural financial institutions that they may not have experience in dealing with and introduce greater demands for management skills.

The best way to deal with these problems is for the underlying growth of the economy to give individual producers and financial institutions enough leeway to restructure their activities. These requires appropriate macroeconomic policies. A difficult issue is how to distribute the inevitable losses from the crisis and the restructuring among the depositors, borrowers, institutions, and taxpayers. The protection of depositors seems important in terms of the future potential for domestic resource mobilization. Financial intermediaries must write off debts that are clearly uncollectable and pursue those than are collectable aggressively. In the end, a critical component of the solution must be a reappraisal of the existing rural financial institutions and instruments, in view of building more robust systems and provide depositors and borrowers with far more options to suit their different demands.

As the world economic environment becomes increasingly subject to rapid and unpredictable changes, it becomes critically important for rural financial institutions to absorb those changes with a minimum disturbance to their viability. Improved financial sector policies, institutions, and technologies are required. Several developing countries have attempted financial reforms to increase the role of market forces in the determination of interest rates and other terms and conditions of financial contracts, the allocation of credit, and the overall scale of intermediation.[10]

These financial reforms have not always produced a successful transition to more efficient and market-oriented financial systems. There is agreement, however, that inconsistent macroeconomic policies have been the main reason for the eventual failure of some of these reforms. In particular, fiscal imbalances have to be reduced for the financial sector not to be repressed. Without retreating to the use of repressive financial measures as desirable instruments of policy, difficult questions about the best way to achieve financial liberalization remain unanswered.[11] The promotion and management of rural financial institutions during a process of financial liberalization continues to be a major challenge.

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[10] See Michael P. Dooley and Donald J. Mathieson, "Financial Liberalization in Developing Countries," Finance and Development, September, 1987, pp. 31-34, as well as The World Bank, World Development Report, 1989, New York: Oxford University Press, 1989.

[11] See Ronald I. McKinnon, "Macroeconomic Instability and Moral Hazard in Banking in a Liberalizing Economy," in Philip L. Brock, Michael B. Connolly, and Claudio Gonzalez-Vega, eds. Latin American Debt and Adjustment, New York: Praeger, 1989.

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